{Section 1} Alarm bells: Faltering living standards from 2003 to 2008

Chapter 3 How Britain measures up

Chapter summary

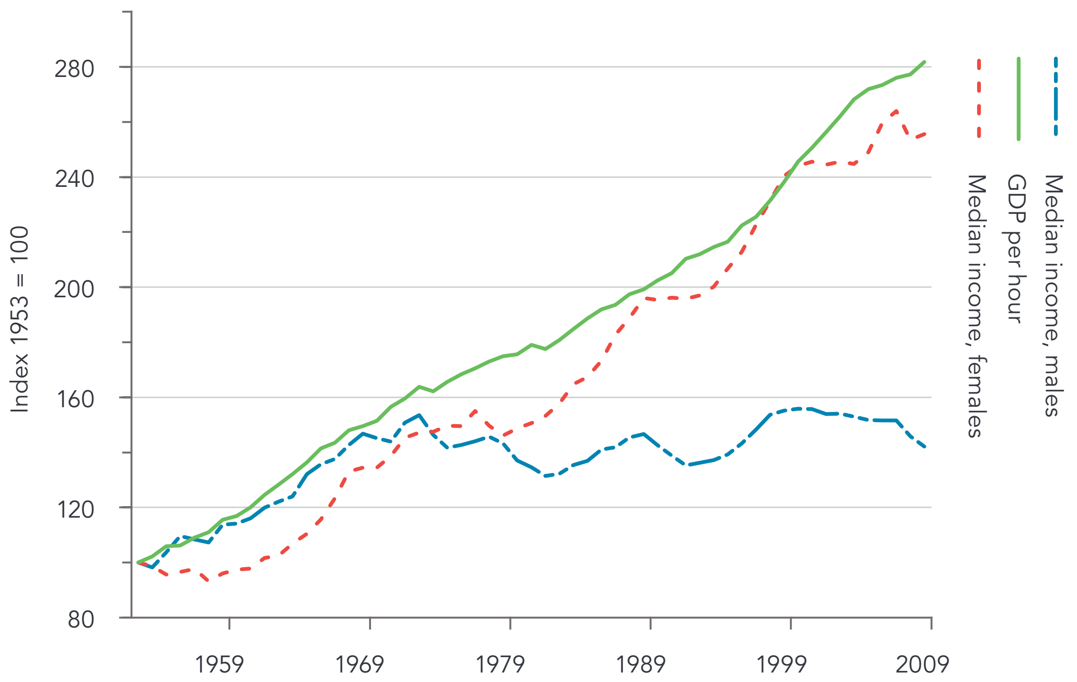
- The UK's short period of stagnation echoes far longer trends elsewhere, particularly in the US where median household income has grown at an average of just 0.2 per cent a year since 1979.
- Different countries vary widely in their ability to deliver rising incomes for low to middle income households, with the UK a relatively good performer when averaged over the long term.
- Internationally, the shape of growth has mattered more than the overall level of growth in delivering rising incomes for low to middle income households.
- Britain's labour market is relatively ineffective at sharing the proceeds of growth, leaving more work for the tax and benefit system to do.
- The UK's effectiveness at sharing growth through the labour market has eroded significantly over time.

The poor performance of incomes in the UK from 2003 onwards carries worrying echoes from other countries, most notably the US (Figure 3.2). US median household income grew by only $3,400, from $46,100 in 1979 to $49,500 in 2010, an annual growth rate of just 0.2 per cent over a 30-year period.[1] As in the much shorter period of income stagnation in the UK, the root cause is a stagnation in employment income.[2] Median earnings for full-time male earners in the US rose by just $100 from 1979 to 2010, though rising much faster for women – by $8,500 – as the gender pay gap narrowed (but did not close).[3] Other trends like soaring household debt are also notably similar in the US and the UK.

3a The US story

The long-running squeeze on US incomes has attracted a lot of debate. This is a far more established phenomenon than the squeeze we have seen in the UK and many researchers have tried to identify its causes.[4] Several factors have been found to be key, most centrally the rise of wage inequality. Rising health insurance costs have also exerted a big squeeze on wages as more of the US labour share has been devoted to this non-wage part of compensation. Original research for the Commission has confirmed these findings.[5] More recently there has also been a debate about the role of changes in the make-up of the US population (see In depth 3.1). Figure 3.1 shows US trends in incomes and labour productivity between 1959 and 2009.

Figure 3.1: US trends in incomes and labour productivity, 1959–2009



Note: Controlled for CPI. Source: US Census Bureau, Current Population Survey, Annual Social and Economic Supplements

[1] Economic Policy Institute analysis of US Census Bureau, *Income, Poverty and Health Insurance Coverage in the United States: 2010 – Historical Income Tables*. [2] For discussion on the importance of compositional changes to US median income stagnation see Landsburg, S., (2012) "The Numbers Racket", http://bit.ly/P06Q0C; Kenworthy, L., (2012), "Wage Stagnation Isn't Due to a Compositional Shift", http://bit.ly/QjPv2F; McNeil, J., (2011), "Changes in Median Household Income: 1969 to 1996", US Census Bureau, http://1.usa.gov/U01Rz0. [3] *Economic Policy Institute analysis of US Census Bureau, (2010), Income, Poverty and Health Insurance Coverage in the United States: 2010 – Historical Income Tables*, Table P-41: Work Experience – All Workers by Median Earnings and Sex. [4] Led in particular by the Hamilton Project at Brookings and the Economic Policy Institute. [5] Pessoa and Van Reenen, *Decoupling of Wage Growth and Productivity Growth?*

In depth 3.1: Is US stagnation explained by compositional changes?

The long-running stagnation in US incomes and earnings has led to lively arguments about causes. One important debate is over the role of changes in the composition of the US population and workforce. Some economists argue that stagnation is largely – or even wholly – explained by the fact that low income groups have expanded in number over time. This has led some to claim that stagnation is an "illusion"; households have not really failed to progress over time, it is just that the mix of households has changed.[6]

The claim that so-called composition effects dispel the need to worry about stagnation rests on a mischaracterisation of the problem. Any measure of median incomes in a country over time results from a constantly changing population. Stagnant median incomes are a worry not because they show that individual households have stopped progressing but because they show that certain parts of society are not becoming better off over time as one would expect.

So rather than being a eureka moment, compositional changes are one possible – and potentially important – explanation for this worrying development. Do compositional effects in fact explain US stagnation? On most dimensions for which there is good data they seem to play a small role. For example, median incomes within the white, Hispanic and black populations have grown faster (in all three cases) than overall median incomes. This apparent contradiction can only be explained by the fact there has been a shift in composition towards lower income Hispanic and black households. Even so, it is not a complete explanation because income growth in each of the three groups has fallen well short of overall GDP growth for much of the last 30 years in the US.[7]

The proportion of the workforce with different levels of skills has also changed over time. There is reason to believe this might have pulled down median earnings. However, even when looking just at college graduates, wage growth has been poor. In the past 35 years, median pay has risen slightly faster for college graduates than for those without degrees, but for the past 20 to 25 years median pay for males with a college degree has stagnated.[8]

In the UK, the most likely culprit for significant compositional effects is immigration, particularly from the A8 accession countries. As we saw in Figure 2.10, these contributions have in fact been small, opening up a gap between median pay for all workers and for UK-born workers of around 1 per cent.

[6] See, for example, Landsburg, "The Numbers Racket". [7] Median US household income among white non-Hispanic households grew from $49,770 in 1984 to $55,410 in 2011, an average annual growth rate of 0.4 per cent; among black households, median household income grew from $27,770 to $32,230 in the same period (a 0.6 per cent growth rate); and for Hispanic households from $35,030 to $38,620 (0.4 per cent). [8] Madrick, J. and Papanikolaou, N., (2007), *The Stagnation of Male Wages*, Schwartz Center for Economic Policy Analysis.

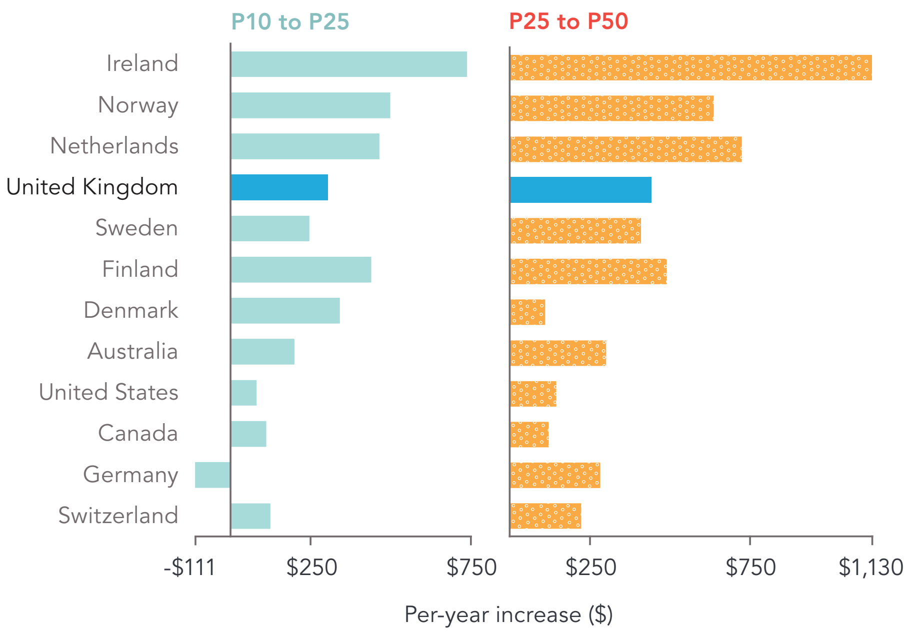
3b The international story

Although the duration of US stagnation of incomes has been exceptional, and has dominated debate about this issue in policy circles, it is not unique. The Commission has carried out a range of new analysis to deepen our understanding of how the relationship between economic growth and personal gains for low to middle income households in the UK measure up against other countries. It reveals that there have been similar trends in a number of countries, including economies as diverse as Canada and Germany, suggesting that more widespread forces may be at work.[9] Looking at other countries beyond the US also helps us see how the UK measures up.

The shape of growth has mattered more than its level

When measuring the extent to which growth has reached low to middle income households over time the UK is a middling performer (Figure 3.2). From 1979 to 2005, income growth for low income households averaged $180 each year and $260 for households on modest income (expressed in dollars controlled for purchasing power). This was far above the US, in which annual growth for these two groups was $50 and $100 respectively, but far below the growth in the Scandinavian economies and the Netherlands (Ireland and Norway are exceptional stories).[10]

Figure 3.2: Average annual growth in earnings in addition to net government transfers in P10 to P50 households, 1979–2005



Notes: The countries are ordered according to average yearly increase in income in P10 to P50 households. The actual years vary somewhat depending on the country. The data are averages for size-adjusted household earnings and net government transfers (cash and near-cash transfers received minus taxes paid). The amounts shown are for a household with four persons; for a one-person household, divide by two. Incomes are adjusted for inflation using the CPI and converted to US dollars using purchasing power parities (PPPs). Source: Resolution Foundation calculations from Kenworthy, L., Why Do Low to Middle Income Households Get Better Off?, calculations using income data from the Luxembourg Income Study Database and inflation and PPP data from the OECD

[9] German Institute for Economic Research, (2009), *Real Wages in Germany: Numerous years of decline*, German Institute for Economic Research Working Paper No. 28/2009; Sharpe, A., Arsenault, J.-F. and Harrison, P., (2008), *The Relationship Between Labour Productivity and Real Wage Growth in Canada and OECD countries*, 1961–2006, Centre for the Study of Living Standards, Ottawa. [10] Low income defined as households between the 10th and 25th percentile of the household income distribution. Modest income defined as households between the 25th and 50th percentile.

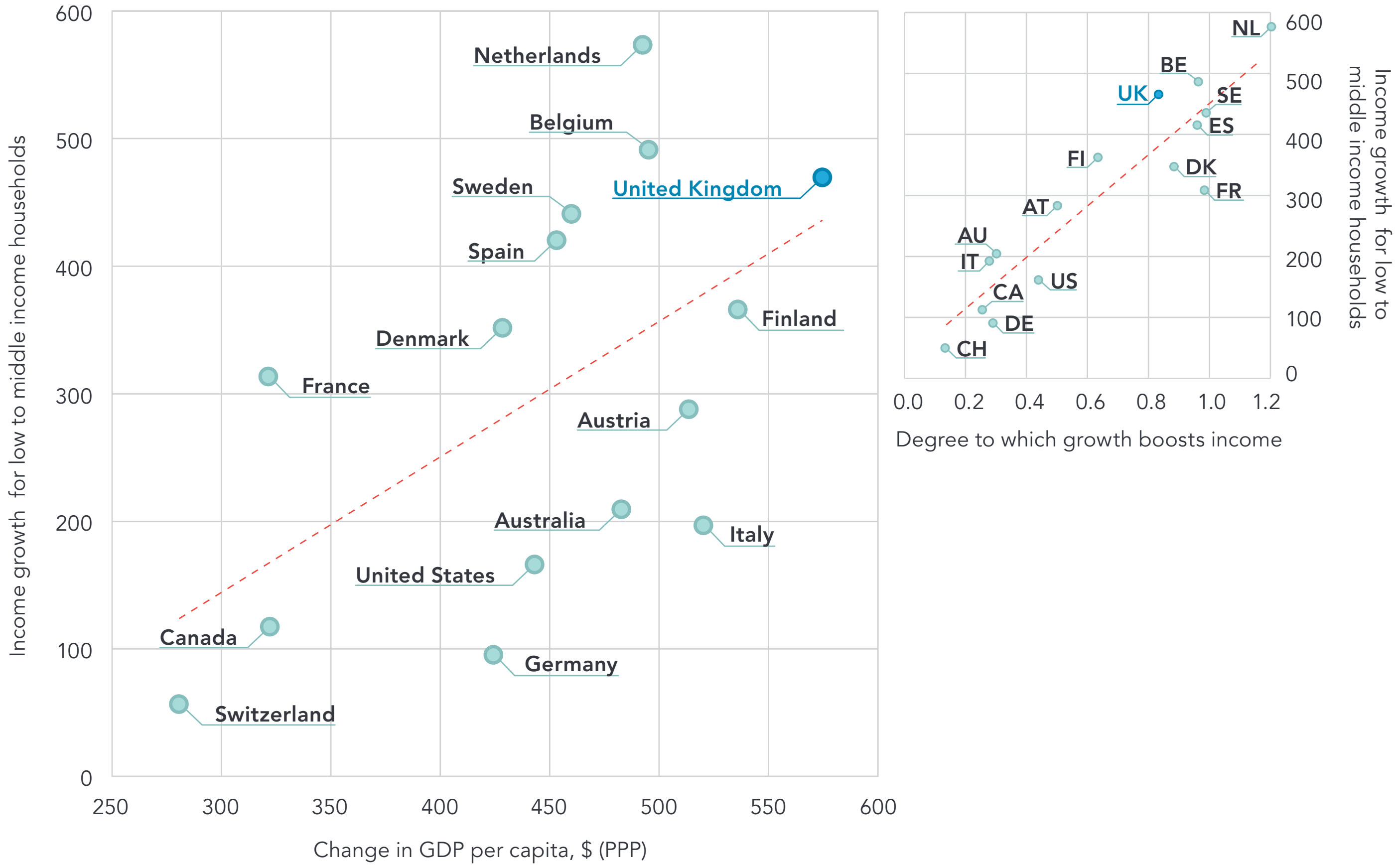
3c The importance of shared growth

Importantly, these trends were explained more by the shape of growth than by its level.[11] Figure 3.3 shows the relationship between GDP growth and income growth for low to middle income households. The fact that the line slopes upwards shows (as one would expect) that countries that grow faster also tend to see greater income growth for low to middle income households.

Yet the fit of the points around the line is relatively weak. This shows that while the overall level of growth clearly matters, it is not a particularly strong explanation for why low to middle income households get better off over time. Some countries grow fast and serve ordinary working households quite badly, while others grow slowly but serve this group well. In this long period from the late 1970s to the early 2000s the UK performed well, particularly in its level of GDP growth.

Rather than the level of growth, it is the shape of GDP growth that matters most for low to middle income households. As one would expect, when we plot a measure that captures this (how much of each part of growth reaches low to middle income households) against income growth for the group, the fit of the points around the line is much tighter. Again, the UK performance looks relatively robust when averaged over this long period (stopping in the early 2000s).

Figure 3.3: Relationship between GDP per capita growth and income growth for low to middle income households (left) and a measure of the shape of growth (right), UK, US and other countries, 1979-2005



Notes: See Figure 6.2. "Shape of growth" relates to the extent to which growth raises incomes. In technical terms, it is represented by the slope from a regression of change in household income on change in GDP per capita. Ireland and Norway are excluded from data since both are extreme outliers in this period. Source: Calculations by Lane Kenworthy using income data from the Luxembourg Income Study Database and inflation and PPP data from the OECD

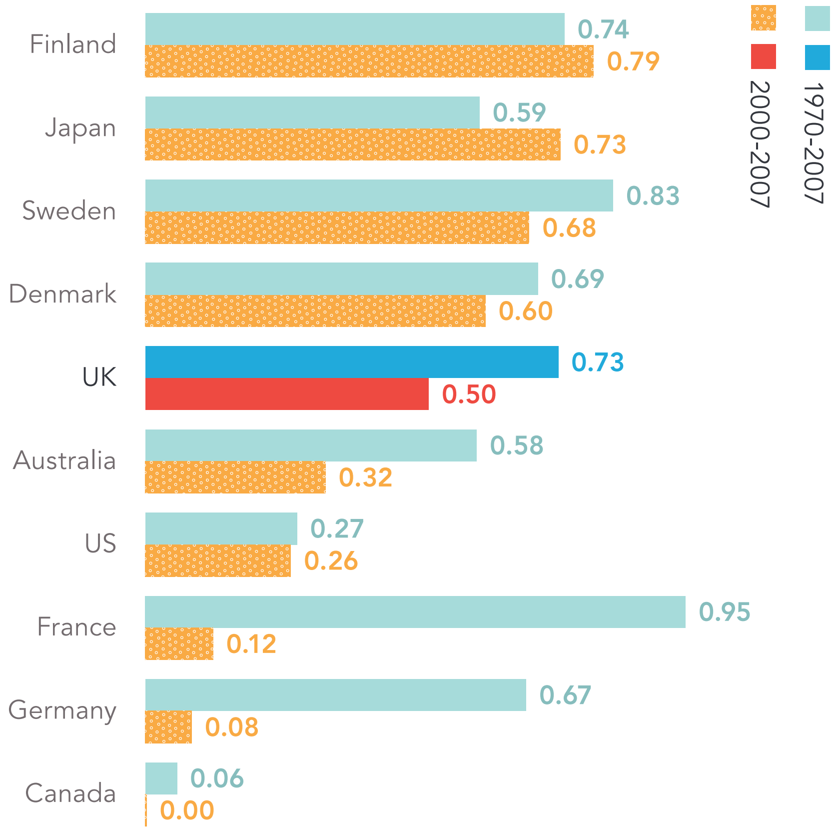
[11]This point is explained in greater detail in Kenworthy, L., (2011), *Why Do Low to Middle Income Households Get Better Off?*, Resolution Foundation, London.

3d The central role of labour market outcomes

Before we go on to examine the UK in more detail in the next section, it is worth looking briefly at the more specific question of earnings growth (before taxes and benefits) to compare how labour markets in different countries affect the link from growth to personal gain.

One useful measure of the effectiveness with which economies share growth is the relationship between economic growth and growth in median wages. In the most recent decade, median wages grew less quickly than economic output in all 10 countries we have studied[12] (Figure 3.4). This fact is remarkable when we consider that for much of the 20th century earnings distributions compressed over time, with median wages outpacing overall growth. The magnitude of this decoupling in the UK has again has been broadly in the middle of that for other countries, with median pay growing at about two-fifths of the rate of GDP per capita compared with four-fifths for Finland, and no growth at all for Canada.

Figure 3.4: Ratio of average annual growth in median pay to average annual growth in GDP per capita, UK, US and other countries, 1970–2007 and 2000–2007



Notes: Ratios below 1 indicate that wages have grown more slowly than output. 2007 is used as the end-point in order to remove the temporary effects of the recent recession. Exceptions are Germany and Finland, where 2008 is used because the recession did not start until the following year in those countries. Sources: OECD Stat; Statistics Sweden; French data provided by Laurence Rioux, INSEE. For more detail on data sources, see Whittaker, Painful Separation[13]

[12] See Whittaker, M., (2011), *Painful Separation: An international study of the weakening relationship between economic growth and the pay of ordinary workers*, Resolution Foundation, London. [13] Ibid

Again we see big variations in the magnitude and persistence of the breakdown in the relationship between growth and gain. Looking back over the 37 years from 1970 to 2007, countries fall into three broad groups:

- *Countries including the US, Australia and Canada, where there has been a pronounced and long-term divergence between economic growth and median wages;*
- *Countries such as the UK, France and Germany, where the breakdown between median wages and growth is more recent but still severe;*
- *Countries including Finland, Japan, Denmark and Sweden, where the breakdown in this relationship is recent and mild, in Japan's case because growth itself has been weak.*

Most countries have a declining "wage share" and rising wage inequality

What explains these variations? Breaking down the relationship between economic output and median wages into three steps – the split between the labour and capital share, between wages and other non-wage compensation and, finally, the distribution of wages – we find that some patterns emerge:

- *There has been a decline in the share of economic output going to labour in most countries, but this has been more severe and consistent over time in the US, Australia and Canada, while the reverse has happened in countries with stronger performance. Until recently the labour share in the UK had held up well, so it has performed comparatively strongly in the long term.*
- *The share of employee rewards being paid as wages has fallen in all countries, associated in particular with rising employer contributions to pensions and social security programmes. Rising non-wage costs appear to be a fact of life in most advanced economies, including the UK.*
- *Inequality in the distribution of pay has increased in all countries. However, this inequality was higher and more likely to increase over the period as a whole in some countries, notably the US and the UK, although growth in inequality slowed markedly in the UK from the mid-1990s.*

If we split out these trends in the UK into separate time periods we see how much these patterns have changed over time (Figure 3.5). From 1980 to 1989, the ratio between GDP growth and median wage growth was 0.95, with each 1 per cent increase in GDP associated with a 0.95 per cent increase in median pay. By 1990 to 1999, this figure had fallen to 0.91, and by the 2000 to 2007 period it had fallen to the 0.50.[14] Almost all of the growth identified in the UK from 2000 to 2007 came in the first three years of the period.

Figure 3.5: The relationship between median wages and GDP growth in the UK, 1980-89, 1990-99 and 2000-07

Notes: Figures show the ratio of average annual growth in median pay to average annual growth in GDP per capita. Figures below 1 indicate that wages have grown more slowly than output. Source: Whittaker, Painful Separation[15]

3e Conclusion

This chapter has put the UK's recent performance into international perspective. While in the closing two decades of the 20th century the UK appeared to be a strong performer, recently this performance has fallen down the rankings. The UK labour market is now particularly poor at distributing the proceeds of growth, leaving the tax and benefit system to do more work.

The next section of the report situates the warning signs of the 2003–2008 period in a longer-term context to explain in much more detail why low to middle income households got better off over time up until 2003. There are three ways in which low to middle income households can get better off: their wages can grow, employment and/or working hours can go up, or the state can do more to boost their incomes (whether through tax cuts or cash transfers). We spend a chapter on each of these three drivers in turn, looking at the effect they have had in Britain. The analysis demonstrates that, although the UK seemed to perform well for a time, we have long been storing up trouble.

[14] Shorter time period chosen to pre-date effects of recession beginning in 2008. See Whittaker, *Painful Separation*, p. 10. [15] Whittaker, Painful Separation.